Editor's note: 93 I.D. 394

PEABODY COAL CO.

IBLA 84-380 Decided September 11, 1986

Appeal from a decision of the Colorado State Office, Bureau of Land Management, denying an application for royalty rate reduction for coal lease C-19885.

Affirmed as modified.

1. Administrative Authority: Estoppel -- Appeals -- Board of Land Appeals -- Federal Employees and Officers: Authority to Bind Government -- Public Lands: Administration -- Secretary of the Interior

   Under 43 CFR 4.1, the Board of Land Appeals is empowered to consider and determine issues raised on appeal as fully and finally as might the Secretary. In considering the significance of actions taken by BLM, the Secretary is not estopped by the principles of res judicata or finality of administrative action from correcting or reversing an erroneous decision by his subordinates or predecessors-in-interest. It necessarily follows that the Board, in exercising the Secretary's review authority, is not required to accept as precedent erroneous decisions made by the Secretary's subordinates.

2. Coal Leases and Permits: Leases -- Coal Leases and Permits: Royalties -- Mineral Leasing Act: Royalties

   Under 30 U.S.C. § 209 (1982), BLM is authorized to reduce the royalty for a coal lease below the minimum specified by statute whenever it is necessary to do so in order to promote development, or whenever the lease cannot be successfully operated under the terms provided therein.

3. Coal Leases and Permits: Leases -- Coal Leases and Permits: Royalties -- Mineral Leasing Act: Royalties

The provisions of 30 U.S.C. § 209 (1982) specify no circumstance in which BLM is required to reduce the royalty of a coal lease. Under that statute, no entitlement to a reduction can ever arise. BLM remains free to accept the economic consequences of denying a reduction. The discretionary authority conferred by sec. 209 enables BLM to exercise prudent business judgment to select the alternative which best protects the economic interest of the United States as owner of the mineral resource.

4. Coal Leases and Permits: Leases -- Coal Leases and Permits: Royalties -- Mineral Leasing Act: Royalties

The "bonus royalty" bid received in a competitive coal lease sale is properly considered a component of fair market value which the Secretary is required to obtain by terms of statute, 30 U.S.C. § 201(a)(1) (1982), and, hence, there is no authority for reduction of that "bonus royalty" just as there is no authority for refund of a "cash bonus" from a lease sale. However, where protection of the interests of the United States requires a reduction in royalty to ensure successful operation of a lease, 30 U.S.C. § 209 (1982) authorizes reduction of the statutory minimum component of the royalty.

5. Coal Leases and Permits: Leases -- Coal Leases and Permits: Royalties -- Mineral Leasing Act: Royalties

When a coal lessee applies for a royalty reduction under 30 U.S.C. § 209 (1982), BLM cannot disregard the fact that the lessee's contracts with its customers provide for passing the royalty through to them. This fact is relevant to a determination of the necessity for royalty relief and must be considered if BLM is not to overstep the authority conferred by 30 U.S.C. § 209 (1982).

APPEARANCES: Michael H. Hyer, Esq., Denver, Colorado, for appellant;

Lyle K. Rising, Esq., Office of the Regional Solicitor, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE ARNESS

Peabody Coal Company (Peabody) appeals from a December 6, 1983, decision of the Colorado State Office, Bureau of Land Management (BLM), denying its application for a 3-year reduction in the royalty rate for coal lease C-19885 from 17.08 to 5 percent. This lease covers approximately 125.16 acres located in lots 5, 6, 7, and 8, sec. 1, T. 5 N., R. 87 W., sixth principal meridian, Routt County, Colorado.

The existing royalty rate of 17.08 percent was selected by Peabody itself as the result of unusual circumstances leading to the issuance of the lease. At the time appellant's lease was issued in 1979, a court had enjoined the Department from issuing coal leases unless there was an on-going mining operation in connection with which the coal could best be removed as part of an orderly mining sequence in order to avoid by-pass of the coal body and a resultant failure to develop the resource. Natural Resources Defense Council v. Hughes, 454 F. Supp. 148 (D.D.C. 1978). The court explained the need for this exception as follows:

> Because of local ownership and reserve patterns, past federal coal leasing practices, and reclamation and other environmental concerns, the failure of the Department to issue a lease to an existing mining operation that could mine an unleased federal coal deposit as part of its ongoing operation may isolate that tract from other coal deposits. This isolation creating "by-passed" coal can make that tract too expensive, either economically or environmentally, to mine in the future. Potentially significant energy supplies which could have been mined with a minimal increment of environmental impact will be lost. Federal royalty receipts, part of which are passed on to the States in which the coal is mined, will also be lost.

Id. at 156. The coal deposit which is subject to appellant's lease was deemed suitable for a "by-pass" leasing arrangement consistent with the court's order because of its location next to appellant's working, non-Federal coal mine.

Nevertheless, issuance of the lease posed a dilemma: although a competitive lease sale was required by statute, see 30 U.S.C. § 201 (1982), 1/ the terms of the court order limited the prospects for competitive bidding on the tract. Thus, the Department had to establish the fair market value of the lease at the time of the sale in order to ascertain the minimum bid which could be accepted. Normally, Federal leases are issued at a fixed statutory royalty rate to the bidder who submits the highest cash bonus exceeding the minimum bid established by BLM. Had the subject lease been issued in this manner, appellant would have been required to pay a minimum bonus bid of $ 4,884.90 per acre. However, as part of an experimental leasing policy tried by the Department for a short time, bidders were permitted to bid for a higher royalty rate instead of submitting so large a cash bonus. Consequently, appellant was offered the following choice: (1) a lease with a 12-1/2 percent royalty rate accompanied by a minimum bonus bid of $ 4,884.90 per acre, or (2) a lease with a 17.08 percent royalty on production coupled with a minimum bonus bid of $ 25 per acre.

The lease was offered competitively on April 10, 1979. Peabody was the only participant, bidding a $ 35.35 per acre bonus payment and a 17.08 percent

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1/ The terms of 30 U.S.C. § 201(a)(1) also expressly provide: "No bid shall be accepted which is less than the fair market value, as determined by the Secretary, of the coal subject to the lease."

bonus royalty. The lease was issued to Peabody effective June 1, 1979. In consideration of Peabody's promise to pay a 17.08 percent royalty and $ 35.35 per acre, the Government did not exercise its right under 30 U.S.C. § 201 (1982) to require Peabody to pay $ 4,884.90 for a lease with a 12-1/2 percent royalty. Peabody now seeks reduction of this royalty to 5 percent.

At first, there may appear to be no valid reason for BLM to relinquish its contractual rights in order to grant such a request from a lessee. However, there may be circumstances where adherence to the original royalty rate would more adversely affect the economic interest of the United States as owner of the mineral deposit than would a reduction of the royalty. The ultimate issue in the adjudication of any royalty reduction request is whether BLM may properly conclude, on the basis of the material submitted by an appellant, that granting a reduction would best serve the interests of the Government.

While the lease is held by Peabody, the coal deposit is within the mine permit area of the Seneca II mine operated jointly by Peabody and Western Utility Corporation. In October 1982, mining progressed onto the extreme northwest corner of the lease. Although not dedicated to a particular buyer, the coal mined under lease C-19885 is marketable under an existing supply agreement to deliver coal from the Seneca II mine to the nearby Hayden Power Plant. However, because Peabody considers the development of additional markets for this coal essential to the prosperity of its operations, on December 21, 1982, it requested a 3-year royalty rate reduction to 5 percent based on a perception the higher royalty rate would render future sales on the open market unprofitable.

BLM forwarded the application with its supporting documents to the Compliance Division, Minerals Management Service (MMS), for an accounting and audit evaluation. MMS recommended that the request for royalty reduction be denied. After reviewing the application and MMS's recommendation, BLM concluded that "the factors or elements used in the royalty rate calculation [at the time of the lease sale] are still correct and [Peabody] has not shown that the lease cannot be successfully exploited" (Decision at 7). BLM grounded its denial of Peabody's application on a lack of sufficient justification for the request.

In its statement of reasons, Peabody asserts that BLM erred by making the conclusion that the economic factors employed in 1979 to determine the royalty rate may still be relied upon. Peabody argues the high rate strongly discourages development and that BLM's reference to the royalty "pass through" clause in the coal supply agreement with Hayden Power Plant as a decisive factor was an abuse of discretion, contrary to Departmental policy, and was inconsistent with BLM's adjudication of other royalty reduction requests. Moreover, Peabody challenges BLM's decision as an irregular "ad hoc" determination made without adequate procedural standards.

Appellant's reference to a Departmental policy raises an initial issue about the scope of this Board's review of BLM's decision. In Kenneth H. Bunch, 37 IBLA 346 (1978), we held that under 43 CFR 4.1, the existence of a Secretarial policy limits review by the Board to the question whether the action under review is consistent with that policy. In Blue Star, Inc., 41 IBLA 333, 335 (1979), we observed that an Assistant Secretary "has the power to act with finality on matters within his or her own province," and dismissed for lack of jurisdiction an appeal from a decision made at the direction of an Assistant Secretary. The Blue Star decision, however, opined that after an appeal was filed with this Board, subsequent action by an Assistant Secretary could not oust this Board's jurisdiction. No action has been taken on Peabody's application which would deprive us of jurisdiction under the Blue Star holding.

[1] Under 43 CFR 4.1, this Board is empowered to consider and determine the issues raised in this appeal "as fully and finally as might the Secretary." In considering the significance of actions taken by BLM which have not been reviewed by higher officials, we must bear in mind that the Secretary of the Interior "is not estopped by the principles of res judicata or finality of administrative action from correcting or reversing an erroneous decision by his subordinates or predecessors in interest." Ideal Basic Industries, Inc. v. Morton, 542 F.2d 1364, 1367 (9th Cir. 1976). "It necessarily follows that this Board, in exercising the Secretary's review authority, is not required to accept as precedent erroneous decisions made by the Secretary's subordinates." Pathfinder Mines Corp., 70 IBLA 264, 278, 90 I.D. 10, 18 (1983), aff'd, Pathfinder Mines Corp. v. Clark, 620 F. Supp. 336 (D. Ariz.), appeal docketed, No. 85-2834 (9th Cir. Nov. 18, 1985).

The issues raised by Peabody in this appeal are matters of first impression with this Board. While we may certainly take cognizance of actions taken by Departmental officials in other cases, our determination of this appeal is governed only by the pertinent statutory and regulatory provisions. Thus, analysis of the legal issues must begin with an examination of those authorities.

[2] Discretionary authority to grant reductions in production royalties is provided in section 39 of the Act, as amended, 30 U.S.C. § 209 (1982):

> The Secretary of the Interior, for the purpose of encouraging the greatest ultimate recovery of coal, oil, gas, oil shale, gilsonite (including all vein-type solid hydrocarbons), phosphate, sodium, potassium and sulphur, and in the interest of conservation of natural resources, is authorized to waive, suspend, or reduce the rental, or minimum royalty, or reduce the royalty on an entire leasehold, or on any tract or portion thereof segregated for royalty purposes, whenever in his judgment it is necessary to do so in order to promote development, or whenever in his judgment the leases cannot be successfully operated under the terms provided therein. [Footnote omitted.]

A request for Federal coal lease royalty reduction is properly made by submission of an application containing specified information. 43 CFR 3485.2(c)(2); cf. 43 CFR 3473.3-2(d) (1982). 2,3 The authorized BLM

2/ Implementation of section 39 of the Mineral Leasing Act, was first addressed in Circular 1341 at 55 I.D. 67 (1934). However, this reference merely identified the existence and general purpose of the statute and Federal coal lease royalty reductions were not mentioned. In 1948, regulations were adopted to establish fundamental procedures to be used when applying for reduction of the royalty rate set by a lease for any of the Mineral Leasing Act minerals. These guidelines have been continued to the present with only minor changes and are now found at 43 CFR 3503.3-2(d). See 13 FR 5641 (Sept. 29, 1948); 29 FR 4509 (Mar. 31, 1964); 35 FR 9708 (June 13, 1970). When a Federal coal management program was developed, royalty reduction guidelines specifically designed for Federal coal leases were promulgated and codified at 43 CFR 3473.3-2 (1979). These regulations were transferred to 30 CFR Part 211 (1982) when MMS assumed responsibilities for the coal program, and now appear at 43 CFR 3485.2, since responsibility for royalty reductions has again been transferred to BLM. See 47 FR 33179 (July 30, 1982); 48 FR 41589 (Sept. 16, 1983).

3/ The Department has consistently held that in no case may royalty rates below the statutory minimum be prescribed as the initial or readjusted terms officer must consider the request and determine whether relief is warranted. 43 CFR 3480.0-6(d)(6), 3485.2(c)(4).

When Congress established a minimum production royalty rate of 12-1/2 percent for Federal coal leases other than those where coal is recovered by underground mining, 30 U.S.C. § 207(a) (1982), the Department considered whether this action precluded BLM from granting reductions below that amount under section 209. The Department concluded that section 209 conferred authority to reduce rates below the statutory minimum. Solicitor's Opinion, 87 I.D. 69 (1979). Any liberality in granting reduction requests, however, would seriously undermine Congress' intent in establishing a minimum production royalty. BLM was mindful of this concern when it issued regulations for its coal management program, and BLM stated the Department's policy in exercising the authority conferred by section 209: "This authority to reduce production royalty below that specified in the lease will be used sparingly, if at all, only upon a convincing showing of hardship, and only for a temporary period or periods on any lease." 44 FR 42584, 42607 (July 19, 1979) (emphasis added).

Why should a lessor ever unilaterally reduce a royalty below the amount it is entitled by law and by contract to receive? Simply because there may be

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fn. 3 (continued)
of any lease. The relief afforded must occur apart from establishment of the basic lease terms. Sunoco Energy Development Co., 84 IBLA 131, 137 (1984); Mid-Continent Coal & Coke Co., 83 IBLA 56, 63 (1984); Coastal States Energy Co., 81 IBLA 171, 179-80 (1984); Solicitor's Opinion, 87 I.D. 69 (1979). See Coastal States Energy Co. v. Watt, 629 F. Supp. 9 (D. Utah 1985), affirming Coastal States Energy Co., 70 IBLA 386 (1983); but see FMC Corp., 74 IBLA 389 (1983), reversed sub nom. FMC Corp. v. Watt, C. 83-0347 (D. Wyo.), appeal docketed, No. 84-2175 (10th Cir. Aug. 29, 1984), cross appeal docketed, No. 84-2208 (10th Cir. Sept. 5, 1984).

circumstances in which the lessor would avoid a greater economic detriment by doing so. If, for example, the authority conferred by section 209 did not exist, a lessee could seek permission to cease operations under 30 U.S.C. § 207 (1982). BLM would then collect only an advance royalty in lieu of a production royalty. A lessee might also choose to relinquish its lease. If the leased deposits can be leased to someone else who can operate more efficiently, the interest to the public as owner of the deposits would be best served by allowing the original lessee to fail. Often, however, Federal leases comprise part of a larger mining operation, and no other operator could perform more efficiently than the existing lessee. Section 209 provides BLM an alternative to accepting relinquishment of a lease or advance royalty in lieu of production royalty. Thus, section 209 enables BLM to maintain a flow of royalty income, although at a diminished level.

[3] Section 209 specifies no circumstance which requires BLM to reduce royalty. Under the statute, no entitlement to such a reduction can ever arise. BLM remains free to accept the economic consequences of denying royalty relief, which may vary from case to case. These consequences may be sufficiently severe to compel a lessee to seek suspension of the condition of continued operation under 30 U.S.C. § 207(b) (1982). Or a lessee might be impelled to relinquish the lease. The discretionary authority conferred by section 209 enables BLM to exercise prudent business judgment to accept the alternative that best protects the economic interest of the United States as owner of the mineral resource. 4/ It necessarily

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4/ The Federal Government is not the primary beneficiary of BLM's prudent exercise of discretion. Although the United States is the owner of the mineral resource, it keeps only 10 percent of the royalties Peabody pays.

follows that if the circumstances of a given case do not confront BLM with such a choice, the case presents no opportunity for BLM to exercise the discretion conferred by section 209. This conclusion is underscored by the fact that section 209 requires BLM to make one of two alternative threshold determinations before its discretionary authority can be invoked: (1) that a reduction "is necessary to promote development," or (2) "the leases cannot be successfully operated under the terms provided therein." On the basis of material that an appellant is required to submit in its application, BLM must be able to find there is a reasonable probability operations would cease or development, recovery, or conservation of the resource would be jeopardized before it can even consider exercising its discretion to grant relief. Otherwise, the Federal mineral owner has nothing to gain by reducing the royalty.

Although appellant emphasizes the phrase "to promote development" in the statutory authorization for reducing royalty, appellant fails to notice the statute includes the limiting word "necessary." Because a royalty operates as a direct cost on development, reduction of royalty would almost always promote development, all other things being equal. Thus, the statute cannot be read to authorize reduction of a royalty whenever doing so would promote development; indeed, the statute only authorizes such action where it is necessary. Keeping in mind that such reductions are to be granted for

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fn. 4 (continued)
Under 30 U.S.C. § 191 (Supp. II 1984), the State of Colorado receives 50 percent and the remaining 40 percent is deposited in the Reclamation Fund established under 43 U.S.C. § 391 (1982). The State's entitlement under 30 U.S.C. § 191 (Supp. II 1984) gives it standing to seek judicial review of Department decisions affecting the amount the State would receive. E.g., Arkla Exploration Co. v. Watt, 548 F. Supp. 466, 472-73 (W.D. Ark. 1982). BLM therefore bears a responsibility to the beneficiaries of the statutory royalty provision to ensure that receipts are not unlawfully diminished.

"the purpose of encouraging the greatest ultimate recovery of coal," and "in the interest of conservation of natural resources," it would not be proper to reduce the royalty if the coal would ultimately be recovered and natural resources conserved in the absence of such a reduction. Unless an applicant shows that these goals cannot be met without a royalty reduction, the statute confers no authority on the Department to grant such a reduction.

Focusing on the second alternative threshold requirement, appellant suggests that the phrase "successfully operated" should be construed to allow a reasonable profit for the lessee. This argument implies that royalty should be reduced whenever a lessee's profits fall below a "reasonable" level. There can be no quarrel with appellant's expectation of a profit. A business certainly has such a motive when it enters into a contract or lease. It is the lessee, however, not the Government, who assumes the risk arising from changing market conditions and increases in the costs of operations. There is no evidence that Congress enacted section 209 to make BLM the guarantor of its lessee's profits. Rather, as stated above, section 209 operates to give the Government additional options to protect its interest as owner of the mineral deposit if the ultimate recovery from that deposit is threatened or when the lease cannot be operated successfully.

Assuming that royalty reductions are usually based on current operational difficulties, Peabody's plea that substantially different economic conditions forecast severe financial difficulty for this leased coal deposit is put into perspective by the observation made in one of the few Departmental decisions reviewing denial of royalty reduction of a Federal coal lease:

> It does not follow, merely because costs have gone up by a considerable amount since the date of the issuance of the lease, that it is impossible to operate successfully under this lease, or that a reduction in the royalty rate is necessary if the land is to be developed for coal mining purposes.

Sheridan-Wyoming Coal Co., A-25845 (June 27, 1950) at 2. The operator in that case showed that increased costs of production indicated the lease could not be profitably developed under the prevailing royalty rate. That argument was rejected and the petition for reduction was denied. The denial was affirmed on appeal.

In addition to the preceding statutory considerations governing the adjudication of applications for royalty relief generally, one other factor affects the disposition of appellant's application. Appellant's lease was not issued for the minimum royalty with a cash bonus; instead of paying a large cash bonus, appellant decided to select a bonus royalty. A bonus offered in the lease bidding process is a payment reflecting the anticipated market value of the coal deposit. Whether the bonus payment is represented by an added royalty percentage or an initial cash outlay, it is an expected expense of developing the lease. There are important differences, however. When a lease is issued on the basis of a nonrefundable cash bonus bid, the fair market value of the lease is primarily reflected in the amount of the cash bonus rather than the royalty. Accordingly, reducing the royalty for such a lease usually does not significantly jeopardize receipt of fair market value. If the fair market value has already been substantially met by a cash bonus, the bonus payment, not being a variable cost, does not inhibit continued development or threaten the successful operation of a mine. 5/ The effect of a bonus royalty is quite different; it defers BLM's realization of fair market value until the lease has been completely mined. It also adds to a lessee's variable costs, i.e., the costs which can be avoided by curtailment of production.

When Congress was considering coal program amendments to the Mineral Leasing Act of 1920, the Department objected to language which would have precluded the Department from issuing leases on the basis of royalty bids. Letter from Jack Horton, Assistant Secretary of the Interior, to James A. Haley, Chairman, Committee on Interior and Insular Affairs, House of Representatives (Mar. 13, 1975), H.R. Rep. No. 94-681, p. 28, reprinted in, 1976 U.S. Code Cong. & Ad. News, 1964-65. As finally enacted, 30 U.S.C. § 201 (1982) contains no such prohibition.

Nevertheless, very few bonus royalty leases have issued, and no adjudicative precedent has been established by the Department regarding management of the bonus royalty. The problems relating to bonus royalty leases, however,

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5/ In Chillicothe Sand & Gravel Co. v. Martin Marietta Corp., 615 F.2d 427, 431, n.5 (7th Cir. 1980), the court defined fixed and variable costs: "Fixed costs are those costs which, in the short run, do not vary with changes in output. Fixed costs generally include items such as management expenses, interest on bonded debt, and other items of irreducible overhead. Variable costs are those costs which in the short run vary with changes in output, including items such as raw materials, labor directly used in production, and per unit royalties. Average cost is the sum of fixed cost and total variable cost, divided by output. The definitions of fixed and variable costs are limited to the short run because all costs are considered variable in the long run."

have attracted concern, both within the Department and outside. On February 20, 1981, the Director, Office of Coal Leasing, Planning and Coordination, Geological Survey, issued a memorandum setting forth the policy recommendations for 11 coal leases issued at above-minimum roylties. This memorandum was approved by the Deputy Assistant Secretary, Land and Water Resources, on February 25, 1981. Different guidelines have been proposed, but not yet adopted. Draft Revision; Royalty Reduction Guidelines for Federal Coal, Phosphate, Potassium, Sodium, Sulphur, and Tar Sand Leases, 50 FR 6062 (Feb. 13, 1985). The policy affecting these leases has been considered by the Government Accounting Office (GAO) in a report dated August 10, 1982. Need for Guidance and Controls on Royalty Act Reductions for Federal Coal Leases, GAO/EMD-82-86. In addition, at pages 211-16 of a report dated February 1984, the Commission on Fair Market Value Policy for Federal Coal Leasing discusses bidding systems for Federal leases, and offers a critical analysis of royalty bidding. The report makes particular reference to coal leases such as appellant's. Although the report recommends that leasing be done on the basis of bonus rather than royalty bidding, it is clear the Department must administer existing bonus royalty leases in a manner consistent with statutory requirements. It must also administer those leases so as to maintain the integrity of the royalty bidding system as long as the statutory authority to conduct royalty bidding remains in effect.

The most significant legal obstacle to reducing the royalty in a bonus royalty lease is the statutory requirement that the Government obtain fair market value as determined at the time of acceptance of the lease. See 30 U.S.C. § 201(a)(1) (1982). Usually this requirement is satisfied when a lessee submits a nonrefundable cash bonus bid. Consequently, the recovery of fair market value is generally not an issue when the bidder of such a lease requests a royalty reduction. Peabody, however, elected to satisfy this requirement with a bonus royalty, deferring BLM's realization of fair market value until the end of the lease term. Therefore, any reduction of royalty in this case may cause a diminution of BLM's realization of the fair market value as that value was determined at the date of lease issuance.

There is one way in which a royalty in a bonus royalty lease can be reduced so as not to violate the requirement that the Government receive fair market value. First, the cash bonus equivalent of the bonus royalty would be calculated as of the date of lease issuance; second, the lessee would be required to submit that amount plus interest compounded to the date of application. By proceeding in this fashion, the royalty can be reduced below the 12-1/2 percent minimum level to the level necessary to ensure successful operation of the lease. Of course, the impracticality of such an approach is obvious. A lessee seeking a reduction might not be in a position to make the required payment, or might choose instead to cease operations or relinquish the lease, thereby diminishing or terminating the flow of royalty payments to the United States. Enforcing the fair market value requirement in this manner could therefore thwart the intent of section 209 that BLM protect the best interest of the United States as the owner of the mineral resource.

Another attempt to reconcile royalty reduction with the fair market value requirement is offered by the 1981 Coal Leasing memorandum cited above. This memorandum suggests dividing the total royalty into two components:

(1) the statutory minimum of 12-1/2 percent and (2) the remainder which is termed the bonus royalty. Appellant suggests that under this analysis, the 12-1/2 percent component of the royalty may be reduced without diminishing the bonus, so the Government's receipt of fair market value would be unaffected. Analysis, however, demonstrates that this approach tends to obscure the fact that appellant is seeking nearly a complete waiver of the statutory royalty. (Only a .43 percent royalty would be left.) One need only compare the consequences of reducing appellant's royalty to 5 percent with the result produced by reducing the royalty of a cash bonus lease to 5 percent. 6/ In the latter situation, the royalty would decline from 12.5 percent to 5 percent, a reduction of 7.5 percent. To reduce appellant's 17.08 percent royalty to 5 percent, a 12.08 percent cut is required, which is 4.58 percent more than the 7.5 percent cut required for the same result, if the lease had been a cash bonus lease. This 4.58 percent difference corresponds to the bonus component of the royalty, which appellant had agreed to pay instead of the $ 4,884.90 per acre bonus bid which represented the fair market value of the lease. Granting appellant's request therefore means that the Government has either surrendered the statutory royalty or waived the bonus royalty. If the former is true, it cannot be in the best interest of the lessor. If the latter, then it is impossible to reconcile the requested reduction of appellant's royalty under section 209 with enforcement of the fair market value requirement of section 201.

6/ This comparison is justified because the royalty level necessary to allow for successful operation of the leased deposit is the same for appellant's bonus lease as it would be had appellant taken a cash bonus lease instead. Because the cost of a cash bonus is a fixed cost which cannot be avoided by curtailment of lease operations, it has no relevance in considering a lessee's short-term incentives to continue mining. Except for the difference in royalty rates, the variable costs of mining are the same under either lease.

Although appellant's application necessarily poses a conflict between these two statutory provisions, the fair market value requirement in section 201 and the relief authority in section 209 have one common objective: the enhancement of the interest of the United States as the owner of the mineral resource. The fair market value requirement was imposed to prevent the United States from leasing resources at less than fair market value. Section 209 ensures the Government will be able to take necessary action when a lease encounters difficulty, in order to see that the economic interests of the United States are not jeopardized.

[4] When the Department saw a similar conflict between section 209 and Congress' specification of a statutory minimum royalty, the Department concluded that section 209 authorized reductions below the specified level. Solicitor's Opinion, supra, 87 I.D. at 69. This construction of the statute assured the Department's ability to take what action was necessary to protect its economic interests. To hold that the fair market value requirement found in section 201 precludes the reduction of any royalty for a bonus royalty lease would frustrate the evident purpose of section 209. Such a construction could force an action which might be economically harmful rather than beneficial. Therefore, it is concluded the statutory objectives are more properly served by holding that, to the extent the interest of the United States may require lowering the statutory minimum royalty (as opposed to the bonus royalty) to whatever level is necessary to ensure successful operation of a lease, section 209 provides such authority. But this holding rests on the premise that section 209 gives BLM authority to grant such relief only when it is in the economic interest of the United States to do so. If the

statutory authority granted under section 209 were any broader, the fair market value requirement established in section 201 would be effectively nullified. Section 209 cannot be construed so as to provide a loophole for lessees to circumvent the requirement that the Government receive fair market value for a lease as determined by conditions in effect at the time of lease issuance.

There is a second consideration which affects granting reduction of bonus royalty leases: the need to assure the integrity of the royalty bidding program. This concern voiced by the Solicitor is not so "specious" as Peabody suggests (Appellant's Reply to BLM's Response at 3). When the Department requested that the coal leasing amendments be drafted to permit royalty bidding, it seemed such a system would encourage greater competition for Federal leases. But if the winner of a bonus royalty lease could later obtain a reduction of royalty below the rate bid by the next highest bidder, such action would be unfair to all potential bidders and could ultimately work against the interests of the United States as the owner of the mineral resource. If appellant were correct in contending that section 209 authorizes the reduction of royalty to a level necessary to provide a lessee with some degree of profit, bidders for royalty bonus leases would have no incentive to base their bids upon market values. Rather, they would be induced to bid royalty rates at whatever level was necessary to win the lease, knowing their bids would not set the rate under which they would ultimately be required to operate.

It is not suggested Peabody selected the 17.08 percent royalty for this lease with the intent to avoid the cash bonus and later have the royalty reduced to a more profitable level. It is clear, however, that the availability of relief undermines the incentives which are necessary for a fair and successful royalty bidding system. Although denying royalty relief may in a particular case work to the disadvantage of the United States, the availability of relief for bonus royalty leases may so modify the incentives of the participants in royalty bidding that the United States would possibly be better served by exercising its discretionary authority to categorically exclude bonus royalty leases from relief under section 209. For the purposes of this appeal, however, the Solicitor contends it is not necessary to go so far in order to deny Peabody's application:

> To allow Peabody to ["be relieved of keeping its bargain"] is to invite acceptance of high royalty rates, instead of cash bonuses, knowing that the company can always obtain a royalty reduction if it guesses wrong on future market conditions. By analogy, if BLM were to sell the fee interest in coal lands for the fair market value at the time (say, 1979) and then 3 years later the buyer wanted a rebate of the purchase price due to cha[n]ged market conditions, the BLM would not even entertain the idea, nor would any private landowner, nor would any court. Neither should BLM do so here. What BLM can do is apply its royalty reduction standards, which require that the operator show operation to be possible only at a loss. There is nothing in that standard which allows subsidizing management's erroneous predictions as to market conditions.

(Solicitor's Brief at 7).

Having stated the general legal considerations governing the adjudication of a request for reduction of royalty in bonus royalty leases, the particular contentions raised by appellant's application can be addressed. As a threshold matter, appellant's application must provide a basis for concluding the lease cannot be successfully operated at the existing royalty rate, or that a reduction of that rate is necessary to promote development of the lease.

Appellant asserts it has shown the existence of an unusual economic condition not encountered when the royalty rate was established in 1979. The application, however, discusses only marketing problems and no assertion is made concerning operation, engineering, or resource-related difficulties arising from conditions on the tract or the nature of the coal. Peabody complains the royalty rate is substantially higher than royalties paid on nearby coal reserves and that inclusion of this Federal coal under its existing coal supply agreement would jeopardize the amount ordered because of its higher price. However, the Seneca II mine has been generally operated by appellant at a profit despite an average price per ton well below the market for the coal sold to Hayden Power Plant. While the low price may be due to pricing provisions in the supply agreement, a September 22, 1981, amendment to the agreement permits Peabody to charge the buyer for increases in actual rents and royalties paid to obtain the coal. Even with the added royalty expense for coal from lease C-19885, the total price per ton of such coal delivered to Hayden Power Plant appears to be below the prevailing market. Hence, the coal extracted from lease C-19885 and sold to Hayden Power Plant would be unaffected by a royalty reduction.

A royalty reduction would therefore merely reduce the uncertainty associated with the opening of new markets. Peabody's prediction for profitable mining of the lease deposit for sale on the open market rests upon its analysis of profit margins and rates of return. Peabody claims that, despite its advantageous position to mine C-19885 under the Seneca II mine operations, its projected rates of return with a 17.08 percent royalty are below minimum levels necessary to justify continued investment in the lease. However, MMS experts reviewed the financial data presented by Peabody and concluded the adjusted rate of return, based on a cash flow determination including depreciation and depletion factors, would be acceptable under industry standards. MMS therefore recommended denial of the request.

Peabody refers to the August 10, 1982, report prepared by the Comptroller General, General Accounting Office, concerning controls on royalty rate reduction for Federal coal leases, and claims BLM's decision violated due process criteria because the decision process lacked proper guidelines or standards. The applicable statute, however, establishes threshold requirements that must be met before royalty reduction can be granted: unless Peabody's application shows that one of the two alternative threshold requirements established by section 209 has been met, this argument raises no issue of dispositive significance.

The GAO report discussed problems encountered by the Department in developing its procedures for reviewing royalty reduction requests. GAO recommended the development of a better defined policy statement and responsive regulations and advocated better use of existing financial expertise in the evaluation process. No new regulations implementing the royalty reduction program have been formally promulgated. Accordingly, it appears BLM has chosen to adhere to the standards stated in the statute and reflected in the regulations found in 43 CFR subpart 3480, cited previously. As suggested by the GAO report, the Acting State Director (the authorized officer reviewing the request) sought the expert advice of the Royalty Compliance Division, MMS. However, MMS' recommendation did not constitute the sole basis for the decision. Instead, the Acting State Director independently applied the facts to the standards found in the statute and, relying upon the provided expert opinion, rendered his determination. This process does not constitute an "ad hoc" decision rendered without guidelines. The criteria and process for review are enumerated in statute and regulation. Appellant has not identified an improper deviation from the outlined review process.

Appellant, however, contends BLM failed to consider its application in a manner consistent with the policy approved by the Deputy Assistant Secretary in 1981. The Solicitor's response to Peabody's appeal fails to address this important issue. Indeed, the Solicitor's only oblique reference to this issue appears on page 4 of its reply brief: "Until the release of this [GAO] report [dated Aug. 10, 1982], the Department had relied on internal guidelines and opinions from the Office of the Solicitor to determine the validity of royalty-reduction requests." Despite the apparent implication that this policy was no longer considered applicable after the issuance of the GAO report, the record contains no evidence the described policy has been revoked. This is not the only issue raised by appellant to which the Solicitor has made no response. Appellant has also alleged that BLM has not been consistent in its consideration of reduction requests for bonus royalty leases, citing in particular requests granted for two leases held by Western Energy Company (Western Energy).

As earlier stated, the 1981 Coal Leasing memorandum attempted to analyze the problem posed by a grant of relief to holders of bonus royalty leases by dividing the royalty into two components: (1) the statutory minimum royalty of 12-1/2 percent, and (2) the remainder, characterized as the bonus royalty. The reason for dividing the royalty rate into two components arose from an effort to make the bonus royalty leases analogous to those leases won by a lump-sum bonus bid. Any amount exceeding the 12-1/2 percent statutory minimum royalty would be analogous to the lump-sum bonus bid. Because an initial cash bonus bid could not be passed to a customer in the same way a royalty could if the lessee's contract with the customer had a royalty pass-through provision, the 1981 Coal Leasing memorandum suggested that, in recalculating the worth of the coal lease by the discounted cash-flow method, it should be assumed the bonus royalty cannot be passed to customers just as a lump-sum bonus bid could not be passed through, even though a lessee's contracts with its customers might contain such a pass-through provision. It should be noticed that this assumption was made only for the purpose of making a discounted cash-flow analysis of the value of the deposits; it does not necessarily follow that the memorandum precluded BLM from taking the pass-through provision into account in making a final determination as to the necessity for royalty relief.

[5] Although Peabody objects to consideration of the fact that appellant's contracts with its customers provide for passing-through the royalty, no statutory basis exists for disregarding a fact of relevance

to a determination of the necessity for royalty relief. If BLM is not to overstep the scope of authority conferred by 30 U.S.C. § 209 (1982), it must determine the necessity for relief on the basis of fact, not fiction. The existence of a royalty pass-through provision is a fact which BLM is not free to disregard. Appellant contends that "a lessee is denied ipso facto any possible remedy under [30 U.S.C. § 209] if there is a royalty pass through provision" (Appellant's Reply to BLM's Response at 2). This contention is not correct. If a lessee could establish that failure to reduce royalty would force its customers to curtail their demand to the extent that operations on the lease would cease, the existence of the pass-through provision would not stand as an obstacle to relief. 7/

BLM's disposition of a request for royalty relief from Western Energy with respect to coal lease M-35735 shows BLM did take into account the distinction between bonus royalty and statutory minimum set forth in the 1981 memorandum. That lease was issued with a royalty rate of 21 percent. In 1981, 1982, and 1983, BLM reduced that rate to the statutory minimum, 12-1/2 percent. By decision dated November 9, 1984, from which Western Energy appealed, BLM determined the rate should be reduced only to

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7/ A notice setting forth draft guidelines for use in handling applications for royalty reductions in Federal leases for renewals including coal was published Feb. 13, 1985. 50 FR 6062. Those draft guidelines would require BLM to take into account royalty pass-through provisions that applicants for royalty relief may have in their contracts with customers. As part of its appeal, Peabody has submitted copies of comments on the draft guidelines, citing the hardship that such consideration of pass-through provisions imposes upon the economy in the West. BLM, however, cannot be blamed for this. BLM did not negotiate the royalty pass-through provisions in appellant's contracts with its customers; nor was BLM a party to those agreements.

16.6 percent. Later, however, BLM moved to vacate its decision and Western Energy asked to withdraw its appeal. The Board remanded the case by order and did not consider the issues raised by that appeal. Western Energy Co., IBLA 85-177 (order dated June 11, 1985).

Accordingly, BLM's decision denying royalty relief is affirmed because appellant has failed to satisfy either of the threshold requirements to enable BLM to exercise its discretion to reduce Peabody's royalty. Even if appellant's applications can be construed as meeting one of the threshold requirements, royalty relief could not be properly granted in the exercise of BLM's discretion because appellant's application does not clearly indicate that the economic interest of the United States as owner of the deposit would be more favorably affected by granting the relief than by denying it.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed as modified by this opinion.

Franklin D. Arness
Administrative Judge

We concur:

Wm. Philip Horton
Chief Administrative Judge

C. Randall Grant, Jr.
Administrative Judge